THE RICHEBÄCHER LETTER

Monthly Analysis of Currencies and Credit Markets

Number 262 **February 1995**

Waiting for the Dollar Crisis

> **"In the manic phase, people of wealth or credit switch out of money or borrow to buy real or illiquid financial assets. In panic, the reverse movement takes place, from real or financial assets to money, or repayment of debt, with a crash in the prices of houses, buildings, land, stocks, bonds – in short in whatever has been the subject of the mania."**
>
> **Manias, Panics and Crashes**
> **Charles P. Kindleberger, 1978**

The new year is barely a month old, and hopes already are fading for a recovery from 1994's savage deflation of bond and stock values. The crisis in the emerging markets, triggered by the collapse of Mexico's overvalued peso, is sending shock waves through the world financial system. Major stock markets also are stumbling badly – as symbolized by the stunning 1,055 point plunge in Japan's Nikkei index on January 23.

Yet Wall Street's misguided bulls refuse to accept the obvious. For each new disaster, they produce a new explanation. Earthquakes in Japan and wars in Russia, dying leaders in China and secessionists in Canada, politics in Spain and sheer economic incompetence in Mexico – all are trotted out to explain the abrupt and brutal failure of the street's sunny forecasts for 1995.

We suffer under no such delusions. We think it should be clear to any reasonably intelligent investor that the financial disasters of recent weeks all are connected. The Great Financial Bubble of the 1990s is in its death throes. Global liquidity is imploding, as over-leveraged speculators struggle to unwind their losing positions. Each new market meltdown only accelerates the flight to cash.

We cannot presume to guess what will trigger the final, general crash. It might be a capitulation by the Dow, which virtually alone has withstood the general carnage. Or a default by a major Mexican bank, triggering a chain reaction in the Euromarkets. Certainly, there is no shortage of possible flash points.

But we think the more important question now is: What comes next? More than anything, the collapse of the bubble brings the long-awaited day of reckoning for the world's big debtor nations, including the United States. Having systematically looted their national savings to support public and private consumption, the deficit countries must adjust to the harsh realities of the post-bubble world – a world of dwindling liquidity, scarce capital and painfully high real interest rates.

Obviously, this spells nothing good for the U.S. dollar. Like Mexico, the United States is highly vulnerable to an abrupt flight by short-term, "hot" money speculators. The world is awash in dollars, yet until recently, sentiment has been almost universally bullish on the U.S. currency. This creates the potential for a sudden, devastating reversal.

Already, currency speculators have been spooked by the obvious, negative implications of the Mexican crisis. Any further shocks, such as a major sell off in the U.S. stock market, easily could precipitate a full-fledged dollar crisis.

THE END OF THE BEGINNING

While 1994 was a surprisingly good year for most economies, it was an unmitigated disaster for the world financial markets. Economic growth proved stronger than expected, and inflation more subdued than many had feared. Yet a series of relatively modest rates hikes by the Fed, which took the federal funds rate from 3% to 5.5%, had a devastating impact on the markets, revealing their extreme vulnerability.

A quick tally of the results over the past year shows the severity of the damage. The epicenter of the quake, of course, was in the U.S. bond market. For Treasury investors, 1994 will go down as the worst since modern record keeping started in 1927.

Holders of the benchmark 30-year bond suffered a loss on their principal of more than 17%. Holders of 5-year notes, meanwhile, suffered a 9% loss, and a total return of -4%. That made 1994 the first year since 1932 in which investors in five-year Treasuries actually lost money.

Global bond markets performed as badly or worse. The total return on the Salomon Brothers World Government Bond Index last year (in local currency terms) was -3.3%. But losses were vastly higher in the more speculative markets, especially those of the big debtor countries. The total return on Salomon's Brady Bond Index was a crushing -16%, reflecting the meltdown in the emerging markets.

World equity markets have been more mixed, although there, too, the vast majority have fallen substantially over the past 12 months. While Morgan Stanley's World Index is down only 2.7% in U.S. dollar terms, that largely reflects the effect of the dollar's steep tumble. On a trade-weighted basis, the dollar has fallen 6% over the past year, and considerably more against both the Deutsche mark (down 12.3%) and the Japanese yen (down 8.5%).

In North America, the Dow has declined 1.7% in the past 12 months, while the S&P 500 has fallen 1.4%. But this seemingly aimless trend conceals considerable erosion in the broader averages. The Nasdaq has dropped 4.2%, while the S&P small-cap index has fallen 7.5%. Canadian markets have generally followed Wall Street. But, with the Canadian dollar's fall against the U.S. dollar, the 9.5% loss in the TSE 300 has translated into a 15.7% loss in U.S. currency terms.

European markets have fared worse. France has fallen 11.1% in dollar terms since a year ago, while the Spanish market has dropped 16.3%. Britain is down 7.1%. Germany posted a 9.1% gain in dollar terms, thanks entirely to the strong Deutsche mark. In local currency terms, the DAX fell 4.4%. Only Italy has bucked the general trend, with the Milan market up 12% in local currency terms, and 20% in dollars.

In Japan, a surge of foreign buying helped push stocks higher in 1994. But last month's plunge pared those gains considerably. The Japanese market has risen only 4.7% in dollar terms over the past year, despite the strong yen. The Australian market, meanwhile, has fallen 11.7%, again in U.S. dollar terms.

The emerging markets, of course, are a complete shambles. Mexico has plunged 61% in dollar terms over the past year. Argentina is down 34.4%. Hong Kong is off 36.5%. Malaysia has fallen 11.4%. Singapore is down 2.1%. Only South Korea (up 3.3% in dollars), Taiwan (up 5.5%) and Brazil (up 5.4%) have bucked the bearish trend.

The most remarkable thing, of course, is the collapse of the Far East high flyers – though most of these economies are regarded as strong and healthy, with high savings and investment ratios. Many people ask, how is this possible? Precisely because these economies looked healthy, they were flooded by international speculation. In any case, investment ratios, too, can become excessive. Japan, which grossly overinvested during the bubble years, is a classic example.

Global Capital Market Trends

Equities

Selected Markets, % Change

Country (January 27)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	-2.5%	-2.6%	-17.2%	-20.4%	1.1%
Canada	-3.6%	-4.1%	-9.5%	-12.3%	2.1%
France	-7.3%	-3.6%	-20.5%	-23.0%	2.3%
Germany	-3.5%	-3.6%	-4.4%	-10.5%	3.6%
Hong Kong	-12.2%	-10.9%	-36.4%	-40.0%	4.7%
Japan	-8.2%	-8.2%	-4.2%	-16.0%	1.8%
Mexico	-14.3%	-17.8%	-28.1%	-32.3%	0.0%
Spain	-1.3%	-1.3%	-21.3%	-23.4%	3.1%
U.K.	-2.0%	-1.4%	-11.8%	-14.2%	5.1%
U.S.	1.7%	2.4%	-1.4%	-2.4%	6.7%

Ten-Year Bond Yields

Selected Markets, Basis Point Change

Country (January 27)	Current Rate (%)	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia	10.23	3	24	378	-48	386
Canada	9.24	16	10	289	-44	334
France	8.08	2	-19	234	-35	239
Germany	7.41	-6	-22	163	-35	171
Japan	4.64	11	11	75	-31	91
Spain	11.79	9	-5	399	-34	409
U.K.	8.57	8	-14	226	-46	236
U.S.	7.61	-15	-21	194	-42	198

Exchange Rates

Versus U.S. Dollar, % Change

Country (January 27)	Current Rate	Month	YTD	Y-Y	Vs. 12-Mo. Hi	Vs. 12-Mo. Lo
Australia ($)	1.32	-2.2%	-2.1%	6.4%	-2.5%	7.6%
Canada ($)	1.42	-1.1%	-0.9%	-7.4%	-7.4%	0.6%
France (FF)	5.26	3.3%	1.4%	10.6%	-3.1%	12.0%
Germany (DM)	1.52	3.8%	2.2%	12.3%	-1.7%	14.1%
Japan (Yen)	99.4	1.0%	0.2%	8.5%	-2.9%	9.6%
Spain (Pta)	131.7	1.3%	-0.1%	6.0%	-6.2%	7.7%
U.K. (Sterling)	1.59	2.8%	1.5%	5.3%	-3.0%	8.7%

THE COMMON CONNECTION

The past 12 months have cost investors a lot of money. But most are still trying to sit their losses out. They pray that the financial markets have put the worst behind them, and hope that the next major, global move will be up, as a slowing U.S. economy brings down interest rates and inflation. Overall, investors remain bullish. We, on the other hand, think this downturn ultimately will prove to be a vicious, prolonged bear market.

As we read about the recent calamities, we are struck by the general penchant to find some particular cause for each and every collapse. In Asia, the impending death of Chinese dictator Deng Xiaoping gets the blame. In Eastern Europe, it's the war in Chechnya. In Mexico, the revolt in Chiapas. Last month's one-day, 1,055 point drop in the Nikkei is blamed on the Kobe earthquake.

This all reminds us of a quip made by Keynes in the 1920s: "Since the public understands particular causes better than general causes, the depression will be attributed to industrial disputes, to the Dawes scheme, to China, to tariffs, to high taxation, to anything in the world except the general monetary policy that set the whole thing going."

The salient point to see here is that the various crashes of the past year are not just random, unrelated events. They share a systemic, deeper-seated common cause: A U.S.-led global liquidity and capital crunch.

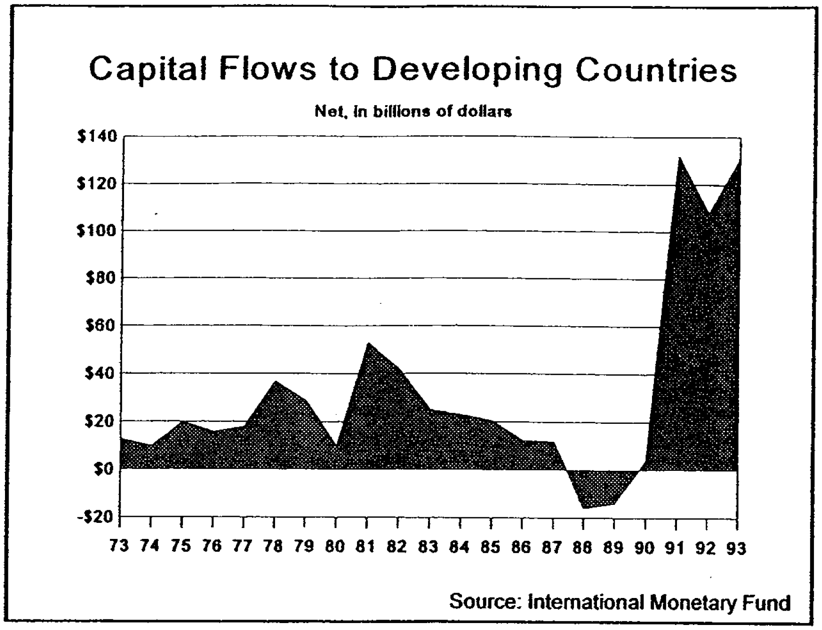
The collapse of the global financial bubble of the early 1990s, which began almost precisely a year ago with the Fed's first, timid rate hike, has led to a general contraction in global capital flows. Everywhere, over-leveraged speculators are in full retreat. Liquidity, which seemed so overwhelmingly abundant during the boom years, is mysteriously vanishing.

As in an epidemic, the weakest are the first to drop. Right now, that means the most heavily indebted deficit countries. The popping of the bubble has triggered a general flight from their currencies and bond markets. Mexico, which foolishly sought to defend a fixed exchange rate despite the sea change in capital flows, has been shattered. The shock waves have been felt around the world.

Oddly, the financial mania of the last few years occurred despite unprecedented weakness in money growth and available savings. In past letters, we have explained in detail what made this paradox possible. Partly, the mania

was powered by a flight from bank deposits into bonds and stocks; and partly by debt leveraging outside the banking system to play the yield curve. This generated no money growth, only a more intensive use of the existing money stock.

In time, this speculative rampage spilled over into the developing countries, sending their debt and equity markets skyrocketing. The chart gives an idea of the magnitude of the frenzy. During the four years 1990-93, net capital inflows into the developing countries averaged $93.7 billion a year. The ironic results: The countries involved were left more vulnerable than ever before to destructive capital flight.

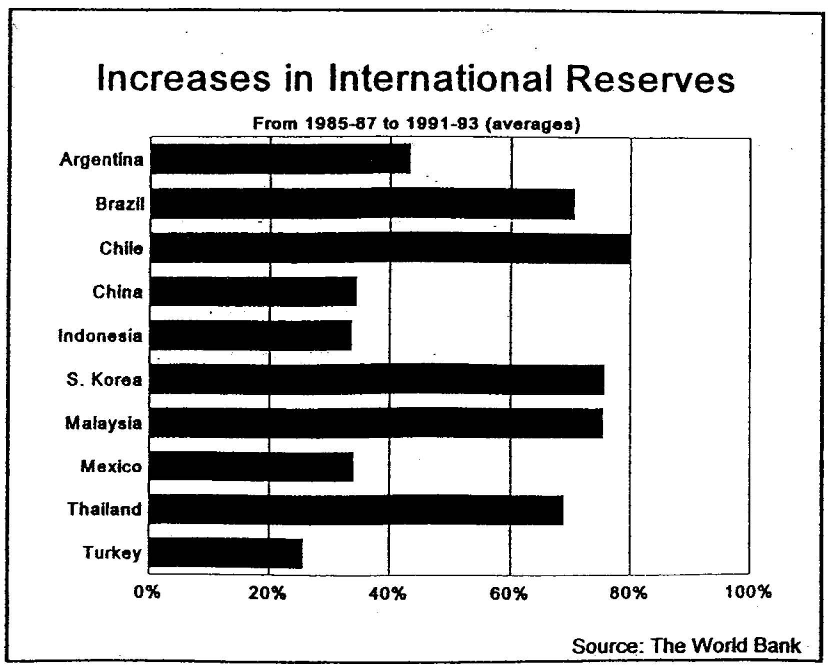


It has been argued that the insatiable appetite for capital of these fast-growing countries was the main reason for the sharp rise in interest rates during 1994. This is rubbish. The big burst of international capital flows in 1990-93 were accompanied by falling, not rising rates. What's more, the Asian developing countries actually have very high domestic savings to match their high rates of net investment. They, at least, haven't burdened the global supply of capital. In any case, the greater part of the capital inflows into the developing countries during the bubble years were recycled via the Fed into U.S. Treasury paper – as we explain below. This lowered, not raised, longer-term rates.

In reality, the huge and excessive capital inflows that poured into the emerging markets in the early 1990s did more harm than good to the recipient countries. The speculative mania exposed them to a host of economic problems, including inflationary pressures, inordinate currency appreciations and deterioration of their current-account balances. To curb these threats, many of the central banks in the developing world accumulated the greater part of the dollar inflows in their international reserves. These reserves, in turn, were then largely reinvested in U.S. Treasury paper.

While it lasted, the craze for emerging markets generated a host of rationalizations. Much was made of their new-found economic dynamism and political stability. With their high growth rates, these countries were said to promise impressive long-term returns.

So much for Wall Street's propaganda. In reality, direct investment in factories, real estate and other productive assets accounted for only about one-third of the capital that flooded into the emerging countries. The rest consisted of portfolio investment and "hot" money deposits. To a large degree, this money couldn't have cared less about long-range economic prospects. It simply was chasing quick capital gains and big



interest-rate differentials. That such flows can reverse overnight used to be common knowledge. Now, this painful lesson is being relearned.

Another key question: What did the capital inflows finance in these countries? In all of them, most of the money went into financial speculation. But, as to the use of the money in the real economies, there was a distinct difference between the developing countries in Latin America and in Asia. In the high-capital countries in Asia, the ratio of private investment to GDP, already over 30% in the mid-1980s, rose by another two percentage points during the following decade. By contrast, investment ratios in the Latin American countries remained relatively flat. This indicates that the capital inflows of recent years were largely used to finance consumption – an unsustainable trend.

In a sense, the current turmoil was foreshadowed by the events of the autumn of 1992, when the crisis of the European Monetary System forced big devaluations in the currencies of Europe's big debtor countries. Now, under even worse liquidity conditions, the same pattern is being replicated globally.

THE MAIN DANGER: ASSET DEFLATION

Yet in general, conventional opinion still focuses on U.S. consumer price inflation as the primary danger facing investors in 1995. We, on the other hand, think this threat pales in comparison to the speculative frenzy that so ludicrously inflated bond and stock prices during the 1990s. While the bubble has been pricked, enormous speculative positions still must be liquidated. This is the main danger overhanging economies and markets.

Asset markets are most seriously at risk when the desire of the public to raise its cash balances clashes with a stagnating or contracting money stock. That's what happened in 1929-33 in the United States and more recently in Japan, and that's what we see happening in the United States today.

Not understanding the real threat, consensus opinion stoically shrugs off the disasters of 1994, returning instead to its familiar bullish forecasts for stocks, bonds, and the dollar. The miraculous event that is supposed bring all this about is the "soft landing" of the U.S. economy – a gentle descent of annual economic growth towards its long-term potential of roughly 2.5%, coupled with a subsiding of inflationary pressures.

Quite a few observers now are sounding positively euphoric about world economic prospects. To them, a financial crash is simply inconceivable. To cite just one example, the January issue of the Bank Credit Analyst includes this glowing endorsement: "In many respects, the domestic and global economic environment is better than at any time since the early 1960s." As evidence for this bold assertion, the BCA cites a dramatic shift in corporate behavior towards greater efficiency and productivity, an increasing commitment of central banks to low inflation, and a widespread rebellion against public-sector excesses.

We hold precisely the opposite view. We believe world financial markets have been dangerously strained by the speculative excesses of the past few years. And we see a world economy that is structurally maladjusted as never before. The decisive factors impairing long-term economic growth and financial stability:

- Unprecedented external imbalances that have left many deficit countries utterly dependent upon permanent, huge capital inflows.

- An equally unprecedented global capital shortage, caused by chronic borrowing binges to finance consumption, both public and private, at the expense of savings and investment.

- A global liquidity squeeze, which, at bottom, is a reflection of the capital shortage. Now that the international financial bubble has burst, the scarcity of global savings is striking the markets with a vengeance.

In recent letters, we have focused on the proximate cause of the current liquidity crunch – that is, on the unwinding of the global bubble created by the Fed. But at this point it seems useful to reexamine the root cause of the crisis: The collapse in savings and capital formation in most of the world's big industrial countries.

By our three measures – external deficits, stagnant capital formation, and contracting liquidity – one regional bloc of countries stands out as by far the worst in the world. That is the group linked together by the North American Free Trade Agreement: the United States, Canada and Mexico. All three have the same overriding problem: a huge structural deficiency in domestic savings. Combined with heavy borrowing for consumption, this has left all three NAFTA countries saddled with chronic, record-high current-account deficits.

Gross National Savings, as a % of GDP

Country	1976-80 (average)	1981-86 (average)	1992
Worst performers:			
Canada	22.2%	19.8%	12.8%
Great Britain	17.8%	16.8%	12.8%
Sweden	18.4%	16.5%	14.1%
United States	20.1%	18.2%	14.5%
Australia	21.6%	18.9%	15.6%
Mexico	21.1%	22.2%	16.1%
Italy	25.8%	22.0%	17.2%
France	24.3%	19.6%	19.8%
Best performers:			
Japan	31.9%	31.1%	33.9%
Austria	25.2%	23.6%	25.1%
Germany	22.2%	21.5%	22.1%

Source: OECD

But the NAFTA triplets are far from alone. The table suggests the global scope of the problem. It shows the steep decline in savings in a number of major countries since 1980 – a development which has been paralleled by an equally drastic decline in investment. This steep fall in savings generally is blamed on excessive government spending. And it is true: With their soaring budget deficits, governments are looting national savings as never before. Public debt in the industrial countries has soared from 40% of GDP in 1980 to over 70% in 1994. Yet during that same time, private savings fell in lockstep – a trend that defies easy explanation.

Whatever the cause, the effect is obvious: The world is short of savings and capital as never before. Inevitably, this imposes a regime of brutally high interest rates – for only in this way can the world's vast appetite for savings be reduced to match the slender supply. For a time, the Fed's easy-money policies ameliorated this condition, by encouraging a speculative flight away from cash and into bonds and other interest-bearing assets. Deprived of this artificial stimulus, rates quickly are returning to their equilibrium levels, and seem likely to shoot past them as the global financial bubble continues to deflate.

CAPITAL STAGNATION

Yet even now, some Wall Street economists claim the United States has a savings surplus. To be sure, U.S. current gross savings presently do exceed current debt growth by a wide margin. But the comparison is totally misleading.

To understand why, it's important to remember that gross savings includes business depreciation on fixed capital – in other words, capital consumption. This, in fact, is both the biggest and the most rapidly rising component of U.S. gross savings. The catch: These depreciation dollars must be reinvested just to maintain the existing capital stock. To support a growing productive base, an economy requires a healthy supply of net national savings. This is the aggregate that measures the supply of domestic savings – over and above depreciation and government budget deficits – available to finance new net investment, that is, additions to the existing capital stock.

Yet in terms of net savings and net investment, the United States is one of the worst cases among the industrial countries. U.S. net national savings – defined as the sum of personal savings, retained business earnings and state and local government pension funds, minus total public-sector deficits – amounted in 1993 to a mere $96.4 billion or 1.5% of GDP. This compares with an average of slightly above 7% in the postwar period until the late 1970s.

In other words, Americans today consume 98.5% of their total output. Over the past two decades, spending on public and private consumption has absorbed a steadily rising share of GDP. This is the deeper cause of the collapse in U.S. net investment and the soaring growth in the U.S. trade deficit.

In every country, flows of funds have the same structural pattern: The household sector runs a financial surplus, while businesses and the public sector typically run financial deficits. If the combined net deficits of firms and governments exceed the savings of households, the inevitable result is a current-account deficit equal to the shortfall.

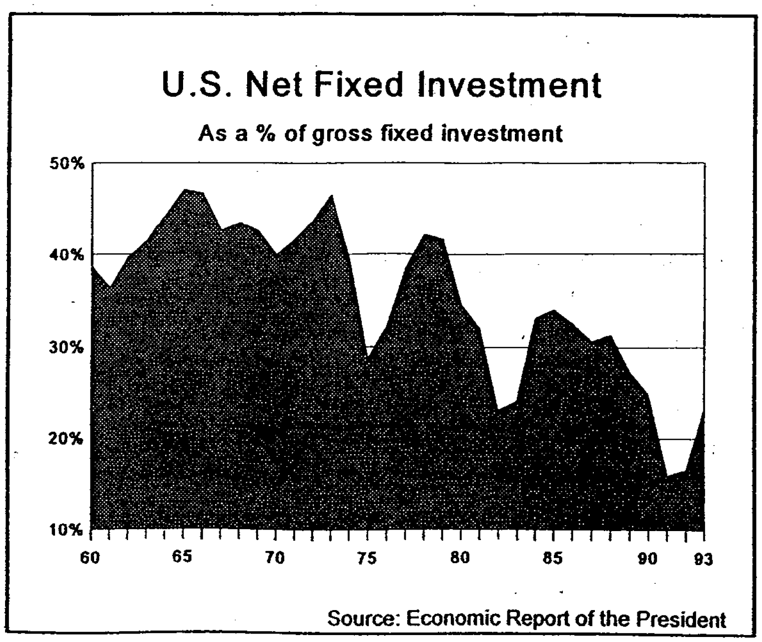
In surplus countries, the reverse is true. Japan's stubborn, big current-account surplus, for example, has its fundamental cause in a persistent excess of personal savings over business and government borrowing. While the Japanese government has boosted its fiscal deficit in recent years to stimulate the economy, this has been more than offset by a sharply contracting financial deficit of the business sector, where investment has all but collapsed.

THE U.S. INVESTMENT MIRAGE

It has become a widely accepted bullish argument that the present U.S. recovery is characterized above all by surging investment. This is thought to promise long-term gains in productivity and competitiveness, allowing the economy to escape the straightjacket of a potential growth rate of a mere 2% or 2.5% a year. But a more sobering conclusion emerges from a more thorough analysis.

The rosy view about a new, improved U.S. investment performance overlooks the crucial difference between gross and net investment. The present strength in investment mainly reflects an acceleration in capital depreciation. This, in turn, stems from a progressive shift to shorter-lived forms of capital: From plant to equipment, and from longer-lived to shorter-lived equipment.

Due to this "shortening" and "deepening" of the investment structure, the U.S. economy requires steadily larger amounts of gross investment just to replace worn-out equipment. The economy, in other words, is growing steadily more capital intensive – despite the scarcity of capital caused by the decline in the U.S. savings rate.



In the long run, what fuels healthy economic growth is investment net of depreciation. While U.S. gross investment presently appears rather strong, net investment has slumped to a historic low of about 2% of GDP, from close to 7% through most of the 1950s, 1960s and 1970s.

To put this trend in perspective: Currently, it takes about five dollars of gross investment to yield a net addition of one dollar to the existing U.S. capital stock, as against a ratio of about three-to-one in the 1970s and 1980s.

Typically, short-lived investments – predominantly in computers, these days – are aimed primarily at defending profits by cutting costs and shedding labor. They add little or nothing to productive capacity. By nature, this investment strategy implies a shift from capital expansion to capital stagnation.

While such short-term, cost-cutting investments have their desired effect on profitability in the short run, they spell lower growth and lower business profits in the long run. Indeed, according to the Austrian school of economics most closely identified with work of Friedrich von Hayek, it's precisely this shrinkage of the structure of production that precipitates the crisis in a stagnating economy.

Finally, we come to another specific feature in the U.S. investment pattern that's really the most worrisome. It concerns its extremely ill-structured sectoral pattern. For many years, both gross and net investment have been skewed towards the trade and financial sectors, as symbolized by the glut of half-empty office buildings and shopping centers still depressing many U.S. commercial real-estate markets. Manufacturing net investment, by contrast, has almost disappeared since the mid-1980s.

Just to give an idea: Between 1990 and 1994, U.S. businesses spent altogether $106 billion on new plant and equipment. But manufacturing investment in 1994 was no higher than in 1990. More than 90% of the increase occurred in the sector defined as "Commercial and Other."

We mention this specific deficiency in U.S. manufacturing investment with a wary eye on the dollar. Though widely ignored, it obviously is one of the main reasons for the large, chronic U.S. trade deficit and the associated dollar weakness.

Essentially, this lack of manufacturing investment severely constrains both U.S. export and import-competing capabilities. U.S. manufacturing may be highly competitive internationally in terms of costs and the dollar exchange rate, but it is unable to play to this advantage because it lacks the necessary capital stock – that is, the capacity to produce tradable goods both for export and to compete with imports.

THE INTERNATIONAL DOLLAR DELUGE

Yet entering the new year, bullish dollar forecasts once again are in vogue in the financial community. Morgan Stanley, to cite just one voice, recently dubbed 1995 "The Year of the Dollar." This may be true – but only in the sense that the last few weeks have been "The Month of the Mexican Peso." In short, we see a looming dollar crisis.

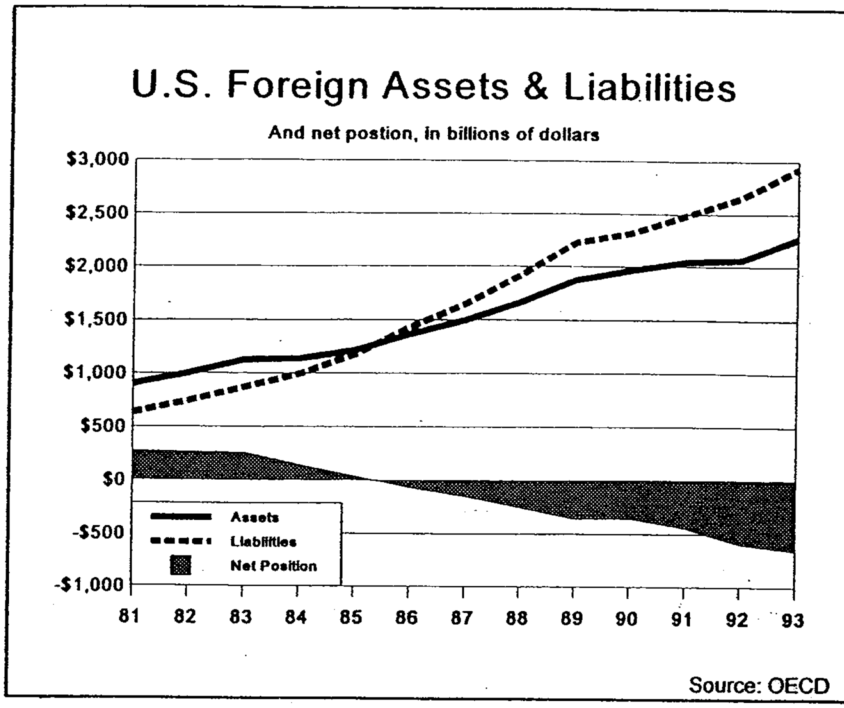
Still, the list of old and new bull arguments for the dollar is longer than ever. The dollar is said to be cheap and undervalued in terms of its purchasing power. As noted above, the United States is believed to be making dramatic gains in competitiveness. Still higher U.S. short-term interest rates, the bulls contend, will enhance the Fed's anti-inflation credibility and fuel rising short-term capital inflows. At the same time, a global economic recovery will generate growing demand for U.S. exports while weaker U.S. domestic demand curbs imports, slashing the U.S. trade deficit. Lower U.S. inflation will revive the bull market in bonds and stocks, and this – it is said – also will attract foreign capital.

The latest, most novel bull argument is that the Mexican crisis will trigger large capital repatriations to the United States, pushing the dollar higher. Clearly, the dollar has a large fan club. Foreigners hold trillions of dollars, and everybody who owns them would like to see them rise in value. Alas, what counts is supply and demand, not wishful thinking.

Since 1981, foreign holdings of dollar assets have quintupled from $600 billion to $3 trillion, including $1 trillion in the short-term liabilities of U.S. banks and their foreign affiliates. During that same period, U.S. corporations and

investors increased their holdings of foreign assets from $900 billion to almost $2.3 trillion. Considering America's dramatic shift from being the world's largest creditor to its largest debtor, the dollar actually has held up remarkably well – until now.

Forecasting the course of the dollar – or any other currency, for that matter – boils down to an assessment of trends in the current and capital accounts. In the third quarter of 1994, the U.S. current-account deficit was running at an annual rate of about -$160 billion. The OECD projects it will total -$173 billion in 1995. This amount constitutes the additional supply of dollars in the international markets that must be absorbed by foreign investors.



The other side of the currency equation – the foreign demand for dollars – is represented by net capital inflows to the United States. This is where the bull story went so disastrously wrong in 1994. Net capital inflows simply failed to keep up with the soaring U.S. trade and current-account deficits. Aggravating the problem: The continuation of an unprecedented *outflow* of U.S. capital to foreign markets.

PRAYING FOR RAIN

For the dollar to rise in 1995, this trend would have to reverse: Capital inflows would have to *exceed* the current-account outflow, plus any continued U.S. capital outflows. All told, this probably would require net inflows in excess of $200 billion.

In our view, capital inflows of this size are absolutely inconceivable, in particular under current global economic and monetary conditions. The bulls argue that the large U.S. current-account deficit is sustainable because it equals only 2.5% of GDP. But this is comparing apples with pears. The decisive issue is not the size of the U.S. deficit relative to GDP, but rather its size relative to the supply of global savings available to finance it. By this gauge, the U.S. current account deficit is truly gigantic, and definitely *not* sustainable in the long run. It seems to us that the long run finally has arrived.

Since 1982, cumulative U.S. current account deficits add up to more than $1.1 trillion. That's a staggering amount. How was disaster staved off for so long? In the 1980s, the dollar benefited from two strong, but fleeting influences. The first was a general underweighting of dollar financial assets in global portfolios after the endless dollar crises of the 1970s. When Paul Volker and the Volker Fed temporarily restored the dollar's credibility in the early 1980s, it triggered an enormous portfolio shift.

In the process, those individuals and institutions who went short the U.S. currency by borrowing heavily in dollars during the inflationary '70s found themselves caught in a monumental short squeeze. The result was a classic buying panic, which quickly pushed the dollar to stratospheric levels. While this rally was quickly undermined by the dramatic deterioration in the U.S. current account, the dollar's decline in the mid-'80s was cushioned by a second factor: The continued excellent performance of U.S. financial markets. This helped sustain the necessary capital

inflows, which in turn helped sustain the U.S. financial markets. This Ponzi-like system even survived the economic recession of the early 1990s, thanks to the Fed's aggressive loose-money policies.

Now, with the popping of the global financial bubble, both props are gone. International investors are grossly overweight dollar assets, and the bullish appeal of the U.S. markets is waning. Like Mexico, the United States has become steadily more dependent on "hot" capital flows, primarily short-term bank deposits. At some point, the dollar, like the peso before it, will face its moment of truth.

Indeed, that moment should have arrived some time ago. Even during the bubble's best years, private capital inflows – hot or cold – were inadequate to cover the U.S. balance-of-payments shortfall. Only the heroic efforts of the world's central bankers, who kept the dollar afloat after 1986 through their heavy, sustained purchases, staved off disaster.

SOME POPULAR DELUSIONS

Now, many observers have been lulled by the comforting thought that the recent fireworks in the emerging markets will provide the support the dollar otherwise so sorely lacks. Shocked by their huge losses in Mexico and elsewhere (the theory goes), U.S. investors will repatriate billions, selling local currencies and buying dollars.

This is nonsense. The emerging countries of Latin America and Southeast Asia all belong to the dollar bloc. Liquidity flows between them and the United States are not apt to affect the dollar's relationship to the key European currencies in any major way. As for U.S. investments in Europe, there are neither signs of nor reasons for repatriation of these, except from weak-currency countries such as Spain.

The truth, rather, is that a massive withdrawal of investors from the emerging markets has direct, negative side effects on the U.S. bond market. To meet the demand for dollars caused by capital flight, central banks of the emerging countries must liquidate their plentiful dollar reserves. For the most part, this involves calling up the New York Fed and ordering it to sell U.S. Treasury paper – until the exhaustion of reserves forces the sellers to float their currencies. As hard as we try, we see nothing positive in this for the dollar.

Equally, we must disappoint those who believe the big flows of capital back to the United States will buoy the U.S. stock and bond markets. Those who hold to these hopes simply reveal their ignorance of the dynamics of a floating exchange-rate system. In a floating system, money cannot flow from country to country. Any holder of Mexican pesos who wants to switch to dollars must find a dollar seller willing to take pesos in exchange. For every dollar buyer who wants to flee Mexico, there must be a seller who wishes to enter.

THIS MEXICO CRISIS IS DIFFERENT – AND MORE DANGEROUS

We continue to read that the present crisis can't be compared to the 1982 Mexico disaster because the Mexican economy is in much better shape. This may be true. But the previous crisis mainly hit the international banking system, which had financed Mexico's huge deficits during the 1970s. When their loans were frozen, they stopped new lending to the developing countries. Leaving aside the devastating impact this had on the countries involved, it essentially was a crisis of the banks.

By contrast, the present crisis is crashing through world financial markets precisely because the capital inflows that sustained Mexico's recent deficits came from a great number of foreign investors through the securities and money markets. Therefore, this crisis has far wider financial repercussions. It hits mostly private investors who are losing their own money, and thus are prone to panic. That's what makes this crisis far more dangerous than the previous one.

For very good reasons, the U.S. Treasury and the Fed are rushing to calm the nerves of those investors with their $40 billion package of Mexican loan guarantees. By extending the full faith and credit of the Treasury to virtually all of Mexico's public and private dollar debt, the Fed and the Clinton Administration hope to head off a full-fledged panic, while still preserving the Fed's room to maneuver.

While the amount is supposed to be impressive, it is grossly insufficient in relation to the money involved. In the absence of capital controls, Mexican citizens are entitled to change their pesos into dollars without limit. In reality, the package is a gamble that the U.S. loan guarantees will nip any capital flight in the bud. If it fails, it would spell incalculable disaster in the whole of North and South America, if not around the world.

Indeed, the stability of the international banking system again could be at stake. During the bubble years, Mexican banks and other financial institutions were hardly blind to the opportunities for leveraged speculation created by the combination of low U.S. short-term rates and an overvalued peso pegged to the dollar. As a result, Mexican borrowers now carry close to $30 billion in Eurodeposits, repos and other private short-term dollar liabilities. A default would bring down banks across Latin America, and easily could trigger a global banking panic.

The problem: Even if the package is approved by the U.S. Congress, it will simply postpone the crisis, not resolve it. Sooner or later, market participants are going to grasp the fundamental irrationality of the notion that the United States, the world's largest debtor, can bail out another big deficit country, i.e. Mexico. In the end, we believe, this will lead to further downward pressure on the dollar, and on U.S. stock and bond markets.

TWILIGHT OF THE DOLLAR

One overriding point should be clear from all of this: Capital flows between debtor and creditor countries are the crucial marginal factor in determining currency valuations. The strength of the currency of a debtor country depends entirely on its ability at all times to attract foreign capital in sufficient magnitude to cover its current-account deficit. This is as true of the United States as it is of Mexico. Yet logic and history both say that this can't work in the long run.

In this respect, the 1980s and early 1990s proved an exceptional era. Though current-account deficits proliferated around the world as never before, they were easily financed – even overfinanced. Lured by enormous interest-rate differentials, international investors and speculators flooded the deficit countries with money in complete disregard of the inherent, long-term exchange-rate risks.

In essence, this international borrowing and lending binge created a global mirage of currency stability and abundant liquidity, together with a growing complacency about the sustainability of perpetual, large deficits. So long as the big money flows continued, the cracks in the global economic structure remained concealed. But at the same time, the speculative frenzy steadily widened these unseen cracks.

After having pampered the deficit countries for so many years, the markets now are turning against them. While the bond carnage was global, the bond markets of the debtor countries were hardest hit. Now, the global liquidity crunch also is pummeling their currencies. This had to happen one day.

But why now? The plain fact is that at long last, the lethal combination of record-low global money growth, a chronic shortage of global savings, and rising demand for liquidity associated with the massive unwinding of speculative positions is taking its toll.

An abrupt upturn in the demand for liquidity has destroyed the mirage of capital abundance. Cash is king, and this is reflected in the steady diminishment of global capital flows. There simply are not enough savings in the world

for every country to attract the amount it requires. This applies with a vengeance to those living beyond their means – that is, to the major deficit countries. Their borrowing and spending binges are running into a brick wall.

Looking at the debtor and deficit countries and their currencies, the fate of the dollar obviously is the most crucial question. Given the large U.S. current-account deficit, the key conditions for a sustained rise of the dollar are bullish U.S. financial markets, outperforming markets in the rest of the world. We simply don't see that happening.

At best, we see a brief rally, once it becomes clear that the U.S. economy is decelerating sharply. But we expect this brief respite to be followed by prolonged bearishness in the U.S. financial markets. This also would be extremely bearish for the dollar.

In recent years, central banks and hot money inflows have been the main sources of support for the dollar. Between 1991 and the third quarter of 1994, central bank purchases of dollars amounted to more than $150 billion. At the same time, U.S. bank liabilities to foreigners soared at a record rate by $240 billion to $965 billion. While U.S. investors stampeded out of low-yielding, short-term dollar assets, foreigners stampeded into them, surely betting on a rising dollar.

But now, as in the mid-1980s, soaring current account deficits are short-circuiting this wave of speculation. Given the structural imbalances in the U.S. economy, and the chronic shortfalls in both savings and investment, it could not be otherwise. The U.S. dollar is poised for yet another downward leg in its long-term, secular bear market.

CONCLUSIONS

Worldwide, financial markets and currencies are crashing. The carnage began in the highly debt-leveraged bond markets. Now, it's hitting the currencies of the debtor nations. Stocks are next. Get out now, before the exit doors slam shut. The global liquidity and capital crunch remains inexorable in its operation.

If, as we presume, the rescue package for Mexico fails to resolve the emerging markets crisis, it is likely to shatter confidence and roil markets around the world by revealing that things now are completely out of control. Among the major currencies, it particularly will hit the U.S. dollar.

We can only repeat our long-standing recommendations: Cash and diversification into liquid assets in the hard-currency countries, primarily Germany, Switzerland, Austria and the Netherlands.

THE RICHEBÄCHER LETTER

DR. KURT RICHEBÄCHER, Publisher and Editor.
Telephone: (49) (69) 74 69 08. Fax: (49) (69) 75 25 83

Bill Montague, Associate Editor

For subscription services and inquiries, please write to: THE RICHEBÄCHER LETTER, 1129 E. Cliff Rd., Burnsville, Minnesota, USA 55337. Subscription orders may be placed toll free from inside the USA by calling **(800) 894-3424**. For all other inquiries, and to order from outside the USA, please call **(612) 894-4088**. Fax: **(612) 895-5526**. Subscription rates: North America, U.S. $400. Outside North America: U.S. $420, or DM 630. Published monthly.